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Before the
Federal Communications Commission
Washington, D.C. 20554

Federal Communications Commission
Office of Secretary

In the matter of)

Implementation of Section 273)
of the Communications Act of)
1934, as amended in the)
Telecommunications Act of 1996)

CC Docket No. 96-254

**COMMENTS OF AD HOC COALITION OF
TELECOMMUNICATIONS MANUFACTURING COMPANIES**

The telecommunications manufacturing companies named in the attachment submit these comments in order to discuss the adoption of regulations to implement Section 273(b) of the Communications Act. That provision provides two important exceptions to the requirement in Section 273(a) that a Bell company refrain from all manufacturing activity until after it is authorized to provide interLATA service within its exchange service territory. The first exception (§273(b)(2)) permits a Bell company, at any time, to enter "royalty agreements" with manufacturers. The second (§273(b)(1)) permits a Bell company, at any time, to engage in "close collaboration" with manufacturers on product design and development. Unfortunately, the Commission implies that it may interpret these two exceptions in a way that would ensure they are almost never used. As we show below, this would be unlawful and would harm telecommunications manufacturers, especially small manufacturers.

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DISCUSSION

I. The Commission Should Not Exclude from the Definition of "Royalty Agreement" an Arrangement Under Which a Bell Company Provides R&D Funding to a Manufacturer In Return for a Royalty Based on the Marketplace Success of Products Developed with that Funding

Section 273(b)(2) states that a Bell company lacking authority to provide in-region interLATA service may enter a "royalty agreement" with an incumbent manufacturer under which the Bell company provides the manufacturer with R&D funding in return for a royalty on products developed with these funds. But the Commission implies that it may prohibit such agreements if the royalty is "paid per unit of sales, or [is] tied to the purchase price of the equipment" on the theory that such agreements may give the Bell company "substantial incentives to favor equipment on which it can collect royalties."^{1/}

For three reasons, the Commission should not exclude from the royalty agreements permitted by Section 273(b)(2) an agreement in which the size of the royalty is tied to the marketplace success of the product whose development the Bell company helped fund. Each reason is discussed below.

First, the statute broadly permits "royalty agreements", and the plain meaning of the word "royalty" includes a payment whose size is tied directly to the marketplace success of the product to which the payment relates as the Commission itself admits.^{2/} The agency points to no legislative history showing that Congress

^{1/} Notice at ¶ 12.

^{2/} Id.

intended the term to have an unconventional meaning for purposes of Section 273(b)(2).

Second, permitting Bell companies to fund a manufacturer's R&D in return for a royalty whose size is tied to the marketplace success of products developed with those funds will be publicly beneficial by stimulating competition in telecommunications manufacturing as the D.C. Circuit already has found.^{3/} Research studies support this court finding given that numerous studies have documented (a) that such collaboration between a manufacturing company and its customers stimulates product development and spreads risk efficiently, and (b) that such contracts are becoming increasingly important to a manufacturer's ability to maintain a competitive market position.^{4/} Indeed, research studies show that marketplace

^{3/} U.S. v. West. Elec. Co., 12 F.3d 225, 243 (D.C. Cir. 1993) (Judge Williams dissenting on other grounds) (such arrangements "are likely to enhance competition in telecommunications products"); Id., 12 F.3d at 234 (majority opinion) (referring to Judge Williams' discussion as an "excellent analysis of current realities in the field of telecommunications").

^{4/} See, e.g., Jakki J. Mohr et al., Legal Ramifications of Strategic Alliances, 3 Marketing Mgmt. 38 (Spring 1994) ("Firms are increasingly relying on strategic alliances and other forms of cooperation to find and maintain competitive advantage."); Ken Mark, All In One Go, Canadian Bus. 39 (Spring 1994) (a manufacturer must collaborate with its customers in order to respond quickly and adeptly to changing customer needs); Antonello Zanfei, Patterns of Collaborative Innovation in the U.S. Telecommun. Industry After Divestiture, 22 Res. Pol'y 309, 310 (1993) (collaborative ventures are a prerequisite for ensuring rapid technological innovation in the telecommunications industry); Eric von Hippel, The Sources of Innovation 76-92 (1988).

success often requires such collaboration in high technology industries like telecommunications.^{5/}

The fact that small manufacturing companies are likely to benefit disproportionately from such agreements likewise shows that they will produce pro-competitive results.^{6/} Assisting small manufacturers is publicly beneficial since small companies are more likely than large manufacturers to complete product development projects successfully and quickly. For example, small firms are quicker to bring innovations to market (3.36 years v. 4.32 years

^{5/} See, e.g., Zanfei, supra; Lorange and Roos, Strategic Alliances at 13-14 (1992) (finding that most manufacturer/customer collaboration agreements are carried out in high-tech industries and that, among all high tech industries, such alliances within the telecommunications industry are the third most common).

^{6/} U.S. v. West. Elec. Co., supra, 12 F.3d at 243 (Judge Williams dissenting on other grounds) ("funding/royalty arrangements are likely to enhance competition in telecommunications products by providing a new source of funding for smaller companies with innovative ideas"). Small manufacturers are likely to benefit disproportionately from these R&D funding/royalty agreements for at least two reasons. First, small companies will have more interest than large companies in negotiating such agreements since their small size limits the absolute amount of internally available cash for R&D activities. Second, small telecommunications manufacturing companies as a group are more R&D-oriented than their large competitors. For example, a typical telecommunications manufacturer with revenues of less than \$500 million spent more than \$17,000 per employee on R&D in 1993, while R&D expenditures of telecommunications manufacturers with more \$500 million in revenues averaged \$9,500 per employee. See "R&D Scorecard", Bus. Wk., June 27, 1994 at 99-100 (figures derived from chart showing R&D expenditures by 24 telecommunications manufacturing companies). The small manufacturer's disproportionately large commitment to R&D also is evident when looking at the percentage of sales revenues devoted to R&D. On average, a small manufacturer has an R&D budget equal to 10 percent of sales revenue whereas a large manufacturer's R&D budget averages five percent of sales. Id.

for large firms.^{2/} In addition, small firms introduce nearly 2.5 times as many new products per \$100 million in sales as do large firms (12.2 for small firms v. 5.0 for large firms), and they obtain more patents per R&D dollar (and per sales dollar) than large firms.^{8/} Further, small firms generate 2.4 times more innovations per employee than large firms.^{2/}

Finally, royalty agreements in which the size of the royalty is tied to the marketplace success of the product on which the royalty is paid not only will stimulate manufacturing competition, they also create little risk. Although the Commission speculates that such agreements may give a Bell company "incentives" to engage in anticompetitive conduct,^{10/} Congress has made plain, by authorizing Bell participation in numerous markets (e.g., cable TV service, incidental interLATA service, out-of-region interLATA service), that an anticompetitive "incentive" is relevant only if it produces a substantial risk that the BOC would actually damage

^{2/} See Keith Edwards & William Wallace, Innovations by Firm Size in Studies of the Bureau of Labor Statistics, in Small Business Research Summary No. 104 (U.S.S.B.A., May 1991) (study of 132 innovative firms).

^{8/} See John A. Hansen, Utilization of New Data for the Assessment of the Level of Innovation in Small American Manufacturing Firms, in Small Business Research Summary No. 101 (U.S.S.B.A., May 1991) (study of 598 U.S. manufacturing firms).

^{2/} See Keith L. Edwards & Theodore J. Gordon, Characterization of Innovations Introduced on the U.S. Market in 1982, in Small Business Research Summary No. 62 (U.S.S.B.A., Mar. 1984) (study of 600 firms from 362 different industries). See also Zolton J. Acs, Small Business Economics: A Global Perspective, Challenge 38 (Nov.-Dec. 1992).

^{10/} Notice at ¶12.

competition in the market at issue. The D.C. Circuit already has determined that royalty agreements of the type at issue here appear to give BOCs no substantial ability to damage competition:

"[Such arrangements] appear likely to limit the potential for... [a Bell company] to engage in the forms of anticompetitive conduct that the manufacturing restrictions were designed to prevent."^{11/}

The Justice Department has concurred.^{12/}

II. The FCC's Speculation to the Contrary Notwithstanding, the Fact Is that Congress Authorized Bell Operating Companies to Engage In "Close Collaboration" With Manufacturers Even if the Collaborating Manufacturer Benefits Competitively from the Collaboration

The FCC's suggestion about how it might interpret Section 273(b)(1) is equally troubling. While that provision permits a Bell company to engage in "close collaboration" with manufacturers on product design and development before it obtains authorization to offer in-region interLATA service, the Commission implies that it may limit permissible collaboration to those types of collaboration that would give the collaborating manufacturer no advantage over a competitor.^{13/}

The FCC should not limit the types of permissible collaboration to those which will keep the collaborating manufacturer from

^{11/} U.S. v. West. Elec. Co., supra, 12 F.3d at 234 (reversing district court order prohibiting Bell companies from entering such arrangements notwithstanding the provision in the MFJ barring Bell involvement in telecommunications manufacturing, and remanding the matter for further consideration).

^{12/} See "Response of the U.S. to the BOCs' Requests for Waivers to Receive Royalties from Certain Sales of Telecommunications Products", U.S. v. West. Elec. Co., No. 82-0192 (D.D.C. March 22, 1995) (filed in the remand proceeding referred to in note 11).

^{13/} Notice at ¶27.

obtaining an advantage over competitors because this would violate the plain meaning of Section 273(b)(1). By its terms, that provision permits close collaboration between a Bell company and a manufacturer without regard to whether the collaborating manufacturer receives a competitive benefit.^{14/}

Even if the plain meaning of Section 273(b)(1) were ambiguous, however, limiting collaboration to situations where the collaborating manufacturer receives no competitive benefit would be inconsistent with Congressional intent since it would make the statutory authorization to collaborate meaningless. This is because all forms of manufacturer/Bell customer collaboration arguably would give the collaborating manufacturer a competitive benefit.

Rather than intending that Section 273(b)(1) provide only a narrow exception to the prohibition against Bell involvement in manufacturing, the Congressional testimony of numerous manufacturers provides strong evidence that Congress instead intended to provide broad collaboration authority on the ground that the benefit of doing so outweighs any competitive advantage that a manufacturer might obtain from such collaboration. For example, the president of Adtran, which makes digital loop transmission equipment, testi-

^{14/} The FCC's network disclosure requirements substantially minimize any competitive advantage in any event. See Implemen. of the Local Comp. Provisions of the Telecomm. Act of 1996, Second Report and Order, ¶¶165-261 (CC Dkt. No. 96-98, rel. Aug. 8, 1996).

fied before Congress that his company had been hurt because of its inability to engage in close collaboration with his Bell customers:

"Because the AT&T consent decree prohibits the Bell companies from having any involvement in the manufacturing process, it is extremely difficult for our 50 product design engineers to communicate freely with our U.S. Bell company customers to ensure that the products we design meet their specific needs."^{15/}

The president of Concept Communications Corp., an R&D company specializing in video teleconferencing, likewise informed the Senate Commerce Committee that his company had been hurt by the inability to collaborate with Bell companies:

"Mr. Chairman, my own company has been handicapped by the MFJ because my company was unable to develop a close working relationship with the Bell Operating Companies. A couple of years ago, U.S. West approached us with a video conferencing idea, neither we nor U.S. West was able to produce this product without the other's help. U.S. West believed that there was a mass market for the product. However, due to the MFJ, we were unable to work with U.S. West in the necessary way required to bring our mutual ideas together, because such collaboration would have involved U.S. West in the manufacturing process. Had we been able to work together, we would have developed a product that would have benefitted both companies and the public. Instead, the economic health of our company was unnecessarily and adversely affected."^{16/}

Even more sadly, the CEO of a telecommunications R&D company had told Congress that his company abandoned efforts to design products

^{15/} The AT&T Consent Decree's Manufacturing Restriction: Hearing before the Subcomm. on Antitrust, Monopolies and Business Rights of the Senate Comm. on the Judiciary, 102 Cong. 1st Sess. 262 (May 21, 1991) (testimony of Mark C. Smith).

^{16/} Telecomm. Equip. Research and Manufacturing Comp. Act of 1991: Hearing before the Senate Subcomm. on Communications of the Comm. on Commerce, Science, and Transp., 102 Cong. 1st Sess. 115 (Feb. 28, 1991) (testimony of Stuart M. Gibson, 3rd).

for local telephone companies because of the inability to collaborate with Bell companies:

"[A]s a result of the roadblocks put on us by [the inability to collaborate with the Bell companies], my company recently has decided to tailor its R&D efforts to product development that meets the needs of companies outside the telephone industry. We've found that it's just too difficult to work in the telephone industry."^{17/}

CONCLUSION

The Commission should not prohibit a Bell company from providing R&D funding to a manufacturer in return for a royalty whose size varies with the marketplace success of products devel-

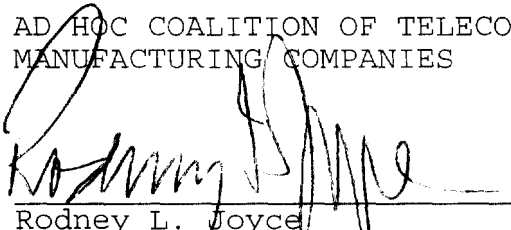
^{17/} Letter from Larry Green, Chief Exec. Officer, Protocol Engines, Inc. to Congressman Thomas J. Bliley (Mar. 6, 1990). While the FCC should not prohibit collaboration merely because it may give collaborating manufacturers a competitive advantage, a Bell company obviously may not collaborate with a manufacturer in a way that directly violates a specific provision in the Communications Act. For example, a Bell company may not disclose to a collaborating manufacturer any information about the protocols or technical requirements described in Section 273(c)(1) until after that information is filed with the FCC since doing so would directly violate Section 273(c)(2). By its express terms, that provision prohibits a Bell company from disclosing such information to a manufacturer until after it is filed with the Commission.

oped with that funding. Nor should the agency bar collaboration between a Bell company and a manufacturer merely because it could give the collaborating manufacturer a competitive advantage.

Respectfully submitted,

AD HOC COALITION OF TELECOMMUNICATIONS
MANUFACTURING COMPANIES

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ATTACHMENT

COMPANIES PARTICIPATING IN AD HOC COALITION OF
TELECOMMUNICATIONS MANUFACTURING COMPANIES
FILING COMMENTS IN CC Dkt. No. 96-254

<u>Company Name</u>	<u>Headquarters Location</u>
Sequoia Electronics	San Jose, California
HealthTech Services Corp.	Northbrook, Illinois
Telemax Corp.	Naperville, Illinois
H & L Instruments	North Hampton, New Hampshire
American Pipe & Plastics, Inc.	Kirkwood, New York
RayTel, Inc.	Philadelphia, Pennsylvania
Axes Technologies Inc.	Carrollton, Texas
LC Technologies, Inc.	Fairfax, Virginia
Remarque Mfg. Corp.	Hampton, Virginia
Telect Inc.	Liberty Lake, Washington